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Related Party Transaction and Financial Reporting Quality: An Empirical Analysis of Indonesia Listed Non-Financial Firms

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Abstract

This study investigates the impact of related party transactions on financial reporting quality in non-financial companies, aiming to validate the reputation theory. This paper employs a quantitative approach using Stata 14 to analyze 354 company observations. The focus of this research is Indonesian non-financial companies, as issuers dominate the IDX capital market. Indonesia is a country characterized by concentrated ownership, which historically has led to expropriation. The focus is on related-party transactions as a limit to expropriation, which can improve the quality of financial reporting. The quality of financial reporting is the goal of issuers using the corporate reputation theory approach, which ultimately benefits minority shareholders. The study finds that related party transactions significantly decrease financial reporting quality. Related party transactions can serve as an effective mechanism for controlling financial reporting quality and strengthening the company's reputation, thereby improving trust among minority shareholders. This research contributes to the understanding of financial reporting quality in non-financial companies listed on the Indonesian Stock Exchange. The study suggests that controlling related party transactions can help attract minority investors by addressing expropriation in concentrated ownership structures.

Keywords: Financial Reporting Quality; Related Party Transactions; Reputation Theory.

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INTRODUCTION

The quality of financial reporting interprets a company's economic performance by providing relevant information to stakeholders. Quality financial reporting emphasizes the financial recording process, which includes information about the company's true capabilities. Quality financial reporting produces quality earnings information, leading to an informed assessment of the company's future cash flows. Quality earnings reflect the actual cash flows generated from the company's operations (Dechow & Dichev, 2002).

In fact, good quality financial reporting tends to have a more efficient allocation of resources, because managers can accurately assess financial conditions, including investment capacity, internal funding capabilities, and liquidity risks (Al-Shaer, 2020; F. Chen et al., 2011; Fan et al., 2022). This implies that the quality of financial reporting serves as an informational infrastructure supporting operational effectiveness and asset management. High-quality financial reporting enhances internal governance mechanisms by strengthening transparency between levels of management and reducing the scope for opportunistic managerial behavior (Lara et al., 2016). However, the corporate ownership structure in Indonesia is characterized by concentration. Concentrated ownership provides room for manager opportunism, which results in increased information asymmetry leading to expropriation (Jiang et al., 2011; Porta et al., 1999).

The issue of concentrated ownership is drawing increasing attention due to the impact of related party transactions. Related party transactions can provide efficiency benefits if they aim to reduce transaction costs and create operational synergies. However, some literature argues that related party transactions are used to transfer company resources to the benefit of related parties, which can be detrimental to minority shareholders (Bona-Sánchez et al., 2017; Cheung et al., 2006; Gordon et al., 2004).

Furthermore, detrimental related-party transactions are a focus of research to improve the protection of minority shareholders. As an emerging market, Indonesia presents a challenge, making improvements to minority shareholder protection a challenge. This means that emerging markets continue to experience growth in terms of increased public share ownership. The role of quality financial reporting in avoiding distortion requires greater attention to related-party transactions as a contributing factor to corporate scandals (Gavana et al., 2022; Gordon et al., 2004).

The reputation theory perspective states that the quality of financial reporting is an important instrument for companies in building an image as a credible, transparent, and trustworthy entity. A company's reputation is formed through stakeholders' long-term assessment of the company's integrity (Ismail et al., 2023). This is supported by the opinion that companies that present financial information in a transparent and conservative manner tend to have a lower risk perception and gain greater trust from external parties (Siddiqui et al., 2023).

This study develops the measurement of related-party transactions in clusters into two categories: assets and liabilities. Several studies have shown that related-party transactions can improve efficiency by facilitating contracts, resource allocation, and operational efficiency within corporate groups, and can support economic needs and corporate expansion (Alhadab & El Diri, 2024). The prevalence of related party transactions, especially with concentrated ownership structures, is of particular concern because it can obscure the true financial health of the company and reduce the quality of financial reporting (Chen et al., 2020).

Our study contributes in two ways. First, it expands research on the relationship between related-party transactions and financial reporting quality in capital markets in emerging markets that have fully adopted international financial reporting standards. Previous studies have been conducted in capital markets in developed countries (Alhadab & El Diri, 2024; Gavana et al., 2022; Gordon et al., 2004), as well as in the capital markets (Habib et al., 2017; Munir et al., 2013). Second, this study provides clusters of related party transaction assets and liabilities.

Literature Review

Related party transactions significantly impact the quality of financial reporting, raising concerns about transparency and potential earnings manipulation. Accurate disclosure of related party transactions is crucial because it allows stakeholders to assess the legitimacy of transactions between a company and its related entities, which often trigger scrutiny from investors and regulators. Growing awareness of the importance of related party transaction disclosure has begun to shape corporate governance norms and practices, particularly in emerging markets.

The main aspect of related party transactions is how they are disclosed in financial reports (ElKelish, 2017). In particular, the presence of these disclosures has been associated with overall earnings quality, as evidenced by the decline in earnings quality when related party transactions are inadequately disclosed or poorly managed (Alhadab et al., 2020; Rahmat et al., 2020).

Related party transactions serve as a tunneling mechanism, where dominant owners exploit minority shareholders. However, related party transactions through financial statements can be controlled by the quality of a company's financial reporting. High-quality financial reporting, in turn, favors protecting minority ownership. In the long run, consistent financial reporting quality leads to a company's reputation. A stronger company reputation leads to higher-quality financial reporting (Cao et al., 2012; Fombrun & Shanley, 1990). Financial reports as information are the main source for external parties of the company, the quality of accounting information plays an important role in forming a strong reputation (Leuz & Wysocki, 2016). Based on previous theoretical and research studies, the following hypothesis is formulated:

$H_1{}^a$: related party transactions assets have a positive effect on financial reporting quality

$H_1{}^b$: related party transactions liabilities have a positive effect on financial reporting quality

METHOD

Our sample, obtained from the Indonesian Stock Exchange, consists of all non-financial companies period 2024. Based on purposive sampling, the data is 354 observations, according to Table 1.

Table 1. Sample selection

Selection Model	Number of Observations
Listed non-financial companies (2024)	667
Less: Missing data / incomplete related proxy	(313)
Total available data	354

Table 2 provides descriptive statistical results from the data processing results through minimum, maximum, average, and standard deviation values.

Table 2. Descriptive statistics

Variable	Minimum	Maximum	Average	Standard Deviation
RPTA	-0.59	2.05	0.26	1.15
RPTL	-10.06	56.36	26.77	3.92
RFQ	-120.09	90.09	66.07	1.34

This research uses cross-section data of non-financial on 2024. The basic model in this research is,

$$\mathbf{RFQi,t = \alpha 0 + \beta 1\ RPTAi,t + \beta 2\ RPTLi,t + \varepsilon_{,}\ (1)}$$

The FRQ was a construct developed model by Dechow & Dichev (2002). It was based on the premise that accruals that mitigate short-term fluctuations in cash flows can enhance the informativeness of earnings. The following model was used:

$$\mathbf{WCAi,t = \beta 0 + \beta 1CFOi,t\text{-}1 + \beta 2CFOi,_t + \beta 3CFOi,_t+1 + \varepsilon i,t \ (2)}$$

Where WCAi,t was working capital accruals, calculated as the change in non-liquid current assets minus the current liabilities, plus the changes in short-term bank debt. CFOi,t-1, CFOi,$_t$, and CFOi,$_t$+1 were the cash flows from operations, expressed by the difference between net income before extraordinary items and total accruals. All the variables were deflated by the total assets-1. The residuals from Equation (3) reflected the variation in working capital accruals that was unexplained by the current year's cash flow and adjacent periods. Therefore, the third measure of FRQ would be the absolute value of the residuals multiplied by a negative one.

Measuring related party transactions (RPT) as an independent variable uses related party transaction assets and liabilities (Jao et al., 2023).

$$\mathbf{RPT}i,t \ \mathbf{Assets} = \frac{RPTi,t\ assets}{Equity}$$

and

$$\mathbf{RPT}i,t \ \mathbf{Liabilities} = \frac{RPTi,t\ liabilities}{Equity}$$

Where RPT_{it} as the related party transactions asset and liabilities ¡ in year t.

RESULTS AND DISCUSSION

Table 3. shows the results of the statistical analysis test of the impact of the independent variable, reporting financial quality on related party transactions.

Regression	Coef	t-stat	p-value	Result
RPTA→RFQ	-0.060	-2.433	0.006	Confirm
RPTL→RFQ	-0.079	-6.012	0.369	Rejected
Constanta	0.118	F-test		0.0003
R-square	0.021			

Where:
RPTA: related party transaction asset
RPTL: related party transaction liabilities
RFQ: reporting financial quality

The results of the regression analysis indicate that related party transactions reduce reporting financial quality. Specifically, the negative coefficient (-0.060) for the relationship between related party transactions (RPTA) and reporting financial quality (RFQ), as evidenced by a t-statistic of -2.344 and p-value of 0.006.

CONCLUSION

The quality of financial reporting of related party transactions in Indonesia is explained by reputation theory. According to reputation theory, related party transactions can be controlled through excellent financial reporting, but they can also arise from opportunistic behavior. According to this study, related party transactions that often take place in several businesses fall under the subcategories of related party transactions (RPTA) and related party transactions (RPTL). Thus, we look into the impact of these subcategories on the quality of financial reporting. We provide proof that a high volume of related party transactions lowers the quality of financial reporting. This suggests that corporate governance benefits the general population. By strengthening minority protection, businesses indirectly enhance their reputation.

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